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DAN SMOOT

TAX REFORM — PART III

The Tax Reform Act of 1969 (as passed by the House and as revised by the Senate Finance Committee) tries to close, partially, the capital-gains "loophole" in the tax code.

In tax language, *capital gain* means the profit one makes from buying and selling certain kinds of property (real estate and shares of stock being the kinds most generally involved). Existing law arbitrarily separates capital gains into two categories: short term and long term.

If one sells property within six months after he bought it, any profit he makes on the deal is classified as a short-term capital gain. The short-term capital gain must be added to the "ordinary income" one has in that tax year, and federal income tax paid on it accordingly, as if it were part of his salary. If one suffers a short-term capital loss in any one tax year, however (buys and sells property within a six-month period and loses money on the deal), he may, for federal income-tax purposes, deduct only $1000 of his loss from his ordinary income. The remainder of his loss may be carried forward and deducted from regular income at the rate of $1000 a year.

Illustration:

A single man earns $50,000 a year in salary. From savings, he buys and sells property within a six-month period of one tax year, enjoying a profit (short-term capital gain) of $50,000 on the deal. The short-term capital gain must be added to his salary for that year, giving him a gross ordinary income for the year of $100,000. His federal income tax on the $100,000 would be $59,824.60. If he had not bought and sold the property (had not made the extra $50,000 in short-term capital gain), his federal income tax on his $50,000 salary that year would have been $23,793. The net result, therefore, is that the federal government took $36,031.60 of the $50,000 he made by risking his savings on a deal that turned out well.

What if it does not turn out well? The man loses $50,000 on the deal (suffers a short-term capital

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loss). He may deduct only $1000 of that loss from his regular income of $50,000. His federal income tax on $49,000 of net "ordinary income" that year would be $23,133.00 — though he actually made nothing at all, because he lost as much on an investment as he made in salary. He may carry forward his loss and deduct it at the rate of $1000 a year. Thus, he must work and pay taxes for 49 more years before getting tax-recognition of the $50,000 he lost on an investment in one year.

If one buys property and holds it for six months or longer, any profit he makes when selling the property is classified (in the present tax code) as a long-term capital gain. One is required to add only half of a long-term capital gain to his ordinary income and pay federal income tax on it as if it were salary (but is never required to pay more than 25% on a long-term capital gain). If one suffers a long-term capital loss (buys property which he holds for six months or longer, and sells at a loss), he may deduct that loss from his regular income at the rate of $1,000 a year (exactly as in the case of a short-term capital loss).

Illustration:

A single man, on a $50,000-a-year salary, sells property which he has owned longer than six months, and gets $50,000 more for the property than he originally paid for it (that is, enjoys a $50,000 long-term capital gain). In the year when the sale is made, he must pay, in federal income tax, 25% of the $50,000 long-term capital gain. His total federal-income tax bill that year is $36,293, whereas it would have been $23,793 if he had not enjoyed the long-term capital gain. The net result, therefore, is that the federal government took $12,500 of the $50,000 he made by risking his savings on a long-term investment that turned out well.

What if the long-term investment does not turn out well? The man loses $50,000 on the deal rather than profits (suffers a long-term capital loss, rather than a long-term capital gain). He may deduct that $50,000 loss (as in the case of short-term capital loss) at the rate of $1000 a year—and will get tax-recognition of his total loss, if he works and pays taxes for another 49 years.

Though these figures prove that the present capital-gains tax is grossly inequitable, they do not reveal all of the inequities of the tax.

Suppose the single man we have used for illustration started working in the 1930's. In 1939, he somehow raised $10,000 and bought shares of stock in some company. In 1969, he sold the stock for $26,400 — $16,400 more than he paid for it in 1939. His tax return for 1969 will show that he made $16,400 in a long-term capital gain in 1969; and he must give one-fourth of that gain — $4100 — to the Internal Revenue Service.

But did he really make any gain at all? He sold the stock for 164% more than he paid for it 30 years ago; but in those 30 years, the value of the dollar has declined (or the cost of living has risen) 164%. At best, he broke even on the deal. Yet, he must pay $4100 for the "profit" he made. In effect, the government is taxing this investor for the inflation that government has caused.

It would be difficult to imagine a tax more unfair than the capital-gains tax. Yet, propaganda about rich people who escape paying federal income taxes has convinced many that the capital-gains tax is a "loophole" for the rich.

The Tax Reform Act of 1969 would tighten this "loophole." The House bill would extend the holding period of property from six months to 12 months before it could be considered a long-term capital investment. The House bill would remove the 25% ceiling on the long-term capital-gains tax, allowing the tax to rise as high as 35%. As revised by the Senate Finance Committee, the Tax Reform Act of 1969 would keep the six-month holding period and keep the 25% ceiling on the long-term capital-gains tax up to $85,000 for single persons, and up to $140,000 for married couples — allowing the tax to rise as high as 35% for taxpayers above those specified brackets. Both versions of the Tax Reform Act would permit only one-half of a person's long-term losses to be offset against his ordinary income (and that, at the rate of $1000 a year).

In previous issues of this *Report*, I have asserted that it is impossible to levy an *income* tax

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without treating some kinds of income differently from others. The capital-gains tax illustrates the truth of this assertion.

Suppose a person makes his living exclusively by buying and selling stocks. If he manages to make a net profit (a capital gain) of $25,000 a year, how shall the federal government tax that $25,000? Why not tax it exactly as if it were income from a salary?

That is the way capital gains were taxed prior to 1933. Then, on March 23, 1933, J. P. Morgan — multimillionaire banker — disclosed in testimony before a Senate committee that he had paid no income tax for the two preceding years, because he had had more capital losses than capital gains in those years.

The country was outraged at the idea of J. P. Morgan paying no income tax. Congress rushed to close a "loophole for the rich." The only way to close the loophole was to treat income earned by buying and selling in the open market as different from income earned by salary.

Now the loophole-closer of 1933 (the ridiculous, complicated, preposterously unfair capital-gains tax) is itself considered a loophole. The Tax Reform Act of 1969 — making the capital-gains tax worse than it was before—will reform nothing. It will discourage the buying and selling of stocks, thus decreasing the amount of private capital made available, through the stock market, for growth and expansion of industry.

Recently, there has been much publicity about "hobby farmers" — usually, city dwellers who have high taxable incomes that cannot be much reduced by legitimate deductions and who, therefore, buy farms that operate at a loss. Deducting their farm losses from their taxable income, they reduce the amount of federal income tax they must pay.

All of this has been decried not only as tax dodging but also as some kind of social evil. But is it? The "hobby farmers" have contributed immensely to the sciences of agriculture and animal husbandry. They have restored fertility to many thousands of acres of worn-out farm land, and have built water systems to sustain cattle or irrigate crops on farms that formerly could produce little or nothing in dry years. They have cleared potentially-productive land of noxious brush, and they have replanted denuded timberlands. They have done all of this because the incomes from their professions or businesses made it possible, and because it was to their benefit to do so.

Would the country — would *anyone* — be better off if the federal government confiscated, and squandered in its unique and multifarious ways, the money that "hobby farmers" spend on their farms?

Obviously not! But that is what the Tax Reform Act of 1969 proposes to do — with complicated computation formulas and qualifying standards which defy understanding.

The "reform" will create a multitude of new inequities. Its worst effect, however, will be the impossible burden of bookkeeping it will impose on owners and operators of small farms. These people cannot afford to hire accountants and lawyers to keep books for the government; but that is what they will have to do to calculate their income tax liability under the "reform" act.

Our federal income-tax system cannot be *reformed*. It is built on inequities and must be *abolished*, so that the federal government will be compelled to adopt a better taxing system.

NEXT WEEK: More on tax reform.

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